Nos. 32 and 33

In the Supreme Court of the United States

OCTOBER TERM, 1948

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

LEWIS F. JACOBSON

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BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the Tax Court of the United States (R. 120–135) is reported in 6 T. C. 1048. The opinion of the Court of Appeals (R. 166–174) is reported in 164 F. 2d 594.

JURISDICTION

The judgments of the Court of Appeals were entered on December 5, 1947. (R. 174–175.) The petition for writs of certiorari was filed on March 5, 1948, and granted on April 5, 1948. (R. 177.) The jurisdiction of this Court is conferred by 28 U. S. C., Sec. 1254.

QUESTION PRESENTED

Whether the taxpayer, who was solvent during the taxable years, realized income, within the meaning of Section 22 (a) of the Revenue Act of 1938 and the Internal Revenue Code and of the applicable Treasury Regulations, when he purchased his own bonds prior to maturity at less than their face value.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1938, c. 289, 52 Stat. 447:

> SEC. 22. GROSS INCOME.
>
> (a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *
>
> (b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this title:
>
> * * * * *
>
> (3) *Gifts, bequests, and devises.*—The value of property acquired by gift, bequest, devise, or inheritance (but the income from

such property shall be included in gross income);

* * * * *

Section 22 (a) and (b) (3) of the Internal Revenue Code (26 U. S. C. 22) is identical with the above provisions.

Treasury Regulations 101, promulgated under the Revenue Act of 1938:

> ART. 22 (a)–14. *Cancellation of indebtedness.*—(a) *In general.*—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. *A taxpayer realizes income by the payment or purchase of his obligations at less than their face value.* (See article 22 (a)–18). * * *
> (Italics supplied.)

Section 19.22 (a)–14 of Treasury Regulations 103, promulgated under the Internal Revenue Code is identical with the above provisions.

STATEMENT

The facts as found by the Tax Court relating to the purchase by the taxpayer of his own bonds (R. 122–127) may be summarized as follows:

The taxpayer is an individual, residing in Chicago, Illinois, where he filed his income tax returns. (R. 122.) The taxable years are 1938, 1939 and 1940. (R. 121.)

In May, 1925, the taxpayer borrowed $90,000 from the South Side Trust and Savings Bank, and he and his wife executed 200 bonds secured by a mortgage trust deed on certain real estate in Illinois to evidence the loan. The proceeds of the loan were used to pay off the existing encumbrance on the property, to pay for an addition to the building which cost $16,250, and to pay the necessary brokerage commissions and expenses in connection with the loan, leaving a small surplus over and above these items which was paid to the taxpayer. (R. 122-123.)

The bonds were payable at the rate of $2,500 semi-annually to and including November 1, 1931, and the balance of $57,500 on May 1, 1932, with interest at 6½% per annum. All of the bonds which became due up to and including November 1, 1931, were paid at or about their respective maturity dates. On June 8, 1931, the South Side Trust and Savings Bank failed to open its doors. (R. 123.)

A bondholders' committee was formed for the bondholders who had purchased bonds on the taxpayer's building. On May 1, 1932, the taxpayer applied to the bondholders' committee and the bondholders themselves for an extension of time for the payment of this loan; and procured an extension to May 1, 1937, for the payment of the principal of the bonds. At no time did the taxpayer default in the payment of interest on the bonds. During this extended period, checks

for interest were issued by the taxpayer directly to the holders of the bonds and were delivered to them by the secretary of the committee. (R. 123.)

In 1937 the taxpayer again procured an extension of time for the payment of the bonds to 1942, and in that connection paid 10% on account of the principal of the bonds, leaving an unpaid balance as of January 1, 1938, of $51,750. (R. 123.)

In 1938, 1939, and 1940, the taxpayer purchased certain of his bonds for amounts less than their face value. Some of the purchases were directly from the holders, and some were through brokerage firms or through the bondholders' committee. (R. 123–126.)[1] There was never any listing of the bonds or a quoted price. Nobody was buying these bonds except the taxpayer. (R. 126.)

At all times during the years 1938, 1939 and 1940, the value of the property securing the bonds exceeded the bonded indebtedness. (R. 126.) The taxpayer owned considerable other property in Chicago besides the property which secured the bonds (R. 127), and had gross income from other sources in excess of $35,000 in each of those years (R. 126). The taxpayer was solvent during each of the taxable years 1938, 1939 and 1940. (R. 127.)

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[1] The following table shows the dates of purchase, method of purchase, face value and purchase price of the taxpayer's bonds which he bought during the taxable years:

Footnote 1 continued on p. 6.

The Tax Court distinguished between the bonds purchased directly from the holders and the bonds purchased through brokers and the bondholders' committee. With respect to the bonds purchased through brokers and the bondholders' committee, the Tax Court held that the difference between the issuance price and the purchase price constituted taxable income under *United States* v. *Kirby Lumber Co.*, 284 U. S. 1. With respect to the bonds purchased through direct negotiations with the bondholders, it held that the difference between the purchase price and the issu-

Footnote 1 continued from p. 5.

Date of purchase	D—Direct B—Broker C—Bondholders' committee	Face value	Purchase price	Percentage of face amount paid by taxpayer
1938				
Apr. 9, 1938 (R. 123-124)	D	$450	$202.50	45
June 9, 1938 (R. 124)	D	3,600	1,620.00	45
Aug. 17, 1938 (R. 124)	D	900	405.00	45
1938 (R. 124)	D	900	957.00	[1] 106
1939				
Feb. 15, 1939 (R. 124)	B	1,800	900.00	50
June 16, 1939 (R. 124)	D	450	225.00	50
Oct 23, 1939 (R. 124)	B	180	86.50	48
1940				
Apr. 4, 1940 (R. 125)	C	270	130.00	48
May 21, 1940 (R. 125)	C	450	210.00	[1] 47
May 23, 1940 (R. 125)	C	2,700	1,080.00	40
June 19, 1940 (R. 125)	C	1,800	720.00	40
July 1, 1940 (R. 125)	B	450	[2] 185.00	41
July 3, 1940 (R. 125)	B	450	[2] 175.00	39
July 10, 1940 (R. 125)	B	450	184.50	41
Sept. 23, 1940 (R. 125)	B	450	185.00	41
Total		15,300	7,265.50	

[1] Approximate figure.

[2] Net.

ance price represented gifts under *Helvering* v. *American Dental Co.*, 318 U. S. 322. Five of the six dissenting judges of the Tax Court expressed the view that the *Kirby Lumber* case governed all the transactions here in question. (R. 132–135.) The court below, on cross-petitions for review, held that the taxpayer had acquired all the bonds by direct negotiations with the bondholders and that in all instances, to the extent of the difference between the purchase price and the issuance price, he received gifts of property exempt from income tax. Accordingly, it held that the taxpayer had not realized taxable income in any of the transactions.

SPECIFICATION OF ERRORS TO BE URGED

The court below erred:

1. In deciding that where the taxpayer purchased his own bonds at less than their face value, the taxpayer did not realize income within the meaning of Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code, and as provided for in the applicable Treasury Regulations.

2. In failing to decide that where the taxpayer purchased his own bonds at less than their face value, he realized income within the meaning of Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code, and as provided for in the applicable Treasury Regulations, regardless of whether he purchased them by direct

negotiations with the holders or through a broker or other intermediary.

3. In reversing that part of the decision of the Tax Court which held that where the taxpayer purchased his own bonds at less than their face value through a broker or other intermediary, he realized income within the meaning of Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code, and as provided for in the applicable Treasury Regulations.

4. In affirming that part of the decision of the Tax Court which held that where the taxpayer purchased his own bonds at less than their face value directly from the bondholders, he did not realize income within the meaning of Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code, and as provided for in the applicable Treasury Regulations.

SUMMARY OF ARGUMENT

I

A taxpayer who purchases his own obligations prior to maturity by paying less than the amount of his obligation thereby increases his net assets and enjoys gains which constitute taxable income. This rule has been stated in long-standing Treasury Regulations and has been approved in *United States v. Kirby Lumber Co.*, 284 U. S. 1, and *Helvering v. American Chicle Co.*, 291 U. S. 426. Contrary to the courts below, the creditor who

accepts less than the face amount of the indebtedness, but who obtains payment prior to the time that it would otherwise be due, does not make a "gift" to his debtor which is exempt from income tax. This is true regardless of whether the debtor purchases his obligations by direct negotiations with his creditor, or otherwise. There is no justifiable basis for the principle followed by the courts below that a tax-exempt gift exists whenever the debtor and creditor deal with each other in direct negotiations. Where each party to the transaction receives and gives up something of value, the transaction is not "gratuitous" and no basis exists for the conclusion that there is a gift of property exempt from income tax. The present case, in this respect, is distinguishable from *Helvering* v. *American Dental Co.*, 318 U. S. 322, where the Court found that there was a gratuitous forgiveness of a past due indebtedness and that the creditor had given "something for nothing" to his debtor; in all pertinent aspects, the case here is governed by the *Kirby Lumber Co.* and *American Chicle Co.* cases.

II

While the situation here can be distinguished from the *American Dental Co.* case, it is also urged that the language of that opinion be reexamined and clarified. It is the Commissioner's contention that a gift of property exempt from in-

come tax does not exist merely because one party to the transaction receives "something for nothing." A proper test for determining whether such a gift has been made depends upon whether the parties were actuated by a donative purpose. Such a purpose is lacking whenever they deal with each other at arm's length and in the ordinary course of business. This has always been the distinction between payments taxable as extra compensation (such as bonuses) and those which are gifts exempt from income tax. It is also the test for determining what transfers are subject to the gift tax. A transfer which is not taxable under the broad scope of the gift tax ought not to be considered a gift under the more narrow provisions of an exemption section in the income tax law. Also, various statutory provisions dealing with specific exceptions to the general rule that income is realized where an indebtedness is modified or discharged at less than the amount of the obligation, indicate that Congress has legislated on the premise that a transaction does not constitute a tax exempt gift to the debtor wherever there has been a gratuitous release by the creditor.

ARGUMENT

I

SINCE (1) SALE OF THE BONDS WAS IN NO SENSE A "GRATUITOUS" ACT ON THE PART OF THE BONDHOLDERS, (2) THE TRANSACTIONS WERE CONDUCTED ON AN ARM'S LENGTH BUSINESS BASIS, AND (3) THERE IS NO EVIDENCE THAT THE BONDHOLDERS HAD ANY INTENTION OF GIVING "SOMETHING FOR NOTHING", THE TAXPAYER REALIZED TAXABLE INCOME BY PURCHASING HIS BONDS PRIOR TO MATURITY AT LESS THAN THEIR FACE VALUE

The problem in this class of cases can be simply expressed. As part of an arm's length business transaction, a debt owed to a creditor by a solvent debtor is discharged. Regardless of the nature of the "property" or "gain" thus acquired by the debtor, he has undoubtedly received an economic benefit and has in fact realized a profit. That profit is of the type that is certainly included in the broad sweep of the definition of gross income of Section 22 (a) of the Internal Revenue Code (*United States* v. *Kirby Lumber Co.*, 284 U. S. 1; see *Helvering* v. *Bruun*, 309 U. S. 461, 469). The question is whether such profit, otherwise includible in Section 22 (a), is to be treated as a "gift" and therefore excluded from income by reason of Section 22 (b) (3).

The answer would seem clear. Since the parties were dealing with each other at arm's length in business transactions supported by consideration, since the creditors obviously had no "donative intent", and since the debtor was certainly not a natural object of his creditors' bounty, there was no

"gift" of income within the meaning of Section 22 (b) (3). The difficulties presented by this case, however, would appear to be attributable to some confusion in the lower courts arising from the language in *Helvering* v. *American Dental Co.*, 318 U. S. 322, which will be discussed later.

Since the issue here is one of statutory construction, we begin our argument by consideration of the words of the statute. Section 22 (a) of the Revenue Act of 1938 and of the Internal Revenue Code (*supra*, pp. 2–3) is couched in terms as broad as the Constitution permits. It defines taxable "gross income" to include "gains * * * derived from * * * businesses, commerce * * * or dealings in property * * * or [from] the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *" Section 22 (a) represents the exercise by Congress of the full measure of its constitutional authority to impose a tax on all income of every nature, and the sweeping character of the definition contained in that section has frequently been noted. *Irwin* v. *Gavit*, 268 U. S. 161, 166; *Douglas* v. *Willcuts*, 296 U. S. 1, 9; *Helvering* v. *Clifford*, 309 U. S. 331, 334. See also *Commissioner* v. *Smith*, 324 U. S. 177, 181, rehearing denied, 324 U. S. 695.

It is clear at the outset, therefore, that the pecuniary gain derived by the taxpayer through the extinguishment of his obligations falls within

the comprehensive definition of taxable income contained in Section 22 (a).[2] The precise question presented in this case is whether, notwithstanding the all-embracing language of Section 22 (a), Congress has, by Section 22 (b) (3), excluded these gains from the taxpayer's gross income because they represent the "value of property acquired by gift * * *" (*supra*, pp. 2–3). This provision is, of course, to be given a restrictive construction no broader than its terms fairly imply, for it has long been established that exemptions are to be strictly construed. Cf. *Irwin* v. *Gavit, supra,* pp. 167–168; *Helvering* v. *Northwest Steel Mills,* 311 U. S. 46, 49.

The court below held that the present case is governed in all material respects by *Helvering* v. *American Dental Co.,* 318 U. S. 322, and that the taxpayer's gains from all the transactions here involved constitute a gift and not taxable income. The court stated that the "controlling feature" of the *American Dental* case was that "the debtor was dealing with its creditors in such a manner that they parted with their security at less than its face value with knowledge that the amount

[2] See Lynch, Some Tax Effects of Cancellation of Indebtedness, 13 Fordham L. Rev. 145 (1944); Warren and Sugarman, Cancellation of Indebtedness and its Tax Consequences, 40 Col. L. Rev. 1326 (1940), 41 Col. L. Rev. 61 (1941); Darrell, Income Tax on Discharge of Indebtedness, 53 Harv. L. Rev. 977 (1940); Surrey, The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness, 49 Yale L. J. 1153 (1940).

received was in discharge of the debtor's obligation" (R. 171). It is respectfully submitted that this statement reflects a misconception of the fundamental principles governing exclusion of gifts from taxable income; that the decision in the *American Dental* case, properly construed, is consistent with the imposition of the tax in this case; and that, to the extent that the court below and other courts may have been misled by language in the *American Dental* opinion into believing that the case establishes a novel or different principle, clarification by this Court would promote consistent and proper application of the tax laws.

The obligations which are the focal point of the present controversy were issued by the taxpayer and his wife in 1925 and were secured by a mortgage trust deed. Some of the bonds were payable prior to November 1, 1931, and those were paid as they became due. The balance, $57,500 face amount, of the bonds would have become due on May 1, 1932. At that time, however, the taxpayer obtained from a bondholders' committee an extension of time for the payment of the principal of the bonds until May 1, 1937. During the extended period he continued to pay the interest. In 1937, the taxpayer paid 10 percent on account of the principal of the bonds, leaving an unpaid balance of $51,750, and in that connection secured a further extension of time for their payment

until 1942. (R. 122-123.) During the taxable years 1938, 1939 and 1940, at a time when the principal of the bonds was not yet due and when there had been no default on the interest payments, the taxpayer bought up from various bondholders a number of bonds of the face amount of $15,300, for which he paid a total of $7,265.50. These bondholders received varying percentages of the face amount of their bonds, ranging from 39 percent to 106 percent. See fn. 1, *supra*. Some of these purchases were accomplished as a result of direct negotiations between the taxpayer and the bondholders, some were acquired through a broker, and some through the secretary of the bondholders' committee. The detailed findings of the Tax Court concerning the individual transactions are set forth at pp. 123-126 of the record.

There is no proof establishing that the bondholders were giving the taxpayer something for nothing, or that they failed to obtain from the taxpayer the full amount of what they then considered to be the value of the obligation—an obligation which was not to become payable for

[3] While the bonds were originally issued by the taxpayer and his wife, there is nothing to show whether, as between the parties, she was intended to have any liability, whether she consented to the extensions of time, or even whether she was still alive. The taxpayer's evidence assumed that he was the sole obligor during the taxable years. For the purpose of this brief a similar assumption will be made for, in the absence of proof to the contrary, it must be conceded that the full amount of the gain determined by the deficiency notice was realized by and taxable to the taxpayer alone.

several more years. Indeed, not only did the taxpayer fail to present evidence to contradict these conclusions, but the only detailed testimony which he gave with respect to some of the transactions shows that the ultimate price paid came as a result of true arm's length business bargaining on both sides, with the creditors attempting to obtain the largest payment possible and being unwilling to wait until the maturity date, and with the taxpayer attempting to pay the smallest amount possible and preferring to postpone payment as long as possible.[4] The facts in the record provide no basis for a suggestion that the taxpayer was the object of the creditors' "bounty".

Where creditors, unwilling to abide their

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[4] The taxpayer described one transaction as follows (R. 32):

> Well, '38, I noticed I had a memorandum on a piece of paper that somebody called me about that bond, and said he had Samuels' bond and represented Samuels and wanted to know how much I would pay for the bond. Samuels was overloaded with bonds. I gave him a figure, I told him if I could get the money, I would take it for 40 cents, but I didn't want to at that time, I wanted him to hang on with me and weather the storm. I didn't hear anything from him, and a year later this same company said they wanted to do something for Samuels and what could I do to get rid of Samuels' bond. We dickered and finally came to an agreement at 50 cents on the dollar, I believe, and then they said they were representing Samuels and I had to go over my whole story, all over again, told them what I had in the world, what I didn't have, what I lost and what I was worth before the crash and what happened to me after that.

debtor's ultimate financial fortunes, bargain for what they consider to be the best amounts immediately obtainable, and where the parties settle the obligation before its due date at less than the face amount, in no fair sense of the word can there be said to be a "gift" of property within the mean-

> and they finally called me up and offered me that and said they would send over the bond for the check.

Respecting another transaction, the taxpayer testified (R. 37):

> Mr. Gerding, who was the secretary of the bondholders' committee told me that some of the bondholders that drifted into his office, wanted to sell their bonds. I told him that was a question of how much money I had to buy with. He told me about Jens Hendrickson and I knew Hendrickson, he had $270.00 principal left, and I told Mr. Gerding that if he wanted to talk to Hendrickson and explain my financial condition which Gerding knew at all times, and if he wanted me to buy his bonds, I would pay him for that service. On April 4, 1940, Mr. Gerding told me that he was ready to buy Hendrickson's bonds if I back him up on it. I said, you just buy the bonds, and I will send you a check. I sent him a check for $130.00, and I said I would pay him for his trouble $7.50.

Generally, concerning the bonds which were purchased through Mr. Gerding, the secretary of the bondholders' committee, the taxpayer stated (R. 39):

> I would rather answer it this way, each one of these people where Gerding finished the deal, I talked to him previously, I gave him my statement of what I could afford to pay and I told him if they wanted to they could bring it over to Gerding, because they could find his office better than mine and they would find him in all of the time, so he was acting as my agent and closed the deal the same as I did.

ing of the exclusion provided for in Section 22 (b) (3). See *Central Paper Co.* v. *Commissioner*, 158 F. 2d 131, 134 (C. C. A. 6); *Chenango Textile Corp.* v. *Commissioner*, 148 F. 2d 296, 297 (C. C. A. 2); cf. *Fifth Ave.-Fourteenth St. Corp.* v. *Commissioner*, 147 F. 2d 453 (C. C. A. 2). The creditors here may have been mistaken in their judgment, for it might have been that the taxpayer would have been able to pay the bonds in full at their maturity; it might even have been the case that the taxpayer, if pressed, would have been willing to pay more than he did to some of the bondholders, for there was a marked variation in the amounts for which he was able to acquire the bonds, the price ranging from 39 to 50 cents on the dollar. Indeed, in one unexplained instance, he paid more than 100 cents on the dollar to one bondholder. (See fn. 1, *supra*.) And there is an express finding by the Tax Court that the taxpayer was solvent during each of the taxable years involved. Be that as it may, a debtor who is able to drive a profitable bargain does not, in any meaningful sense of the word, receive a gift, and, conversely, a creditor who makes a poor or even a foolish bargain does not thereby make a gift to his debtor.

The situation here is one where, even under the common law principles of contract law, the mutual promises (even if they had still been executory) would have been enforceable because supported by consideration. The taxpayer by promising to pay prior to maturity gave sufficient considera-

tion for the creditor's promise thereby to accept less than the amount which would have otherwise been due at maturity. *Crow* v. *Gore*, 85 F. 2d 291, 293–294 (App. D. C.); 1 Restatement of the Law of Contracts, Section 84 (c); 1 Williston on Contracts (Rev. ed., 1936), Section 121. It would be a contradiction in terms to hold that a transfer of property, pursuant to an enforceable contract supported by common-law consideration, is a "gift of property" which Congress has exempted from income tax. *Carroll-McCreary Co.* v. *Commissioner*, 124 F. 2d 303, 305 (C. C. A. 2); *Chenango Textile Corp.* v. *Commissioner, supra.*

Our argument does not imply that every transaction which lacks technical consideration, or would not be an enforceable contract at common law for any other reason, thereby automatically qualifies as a gift within the meaning of Section 22 (b) (3). Indeed, a bonus given to an employee is a familiar example of taxable income, notwithstanding the absence of any obligation on the part of the employer to make the payment. The short of this case is that Congress never intended that a gain should be viewed as a gift and exempt from the income tax when it represents the fruition of a true business bargain possessing the elements of mutual good and sufficient consideration.

Plainly, therefore, the present case is distinguishable from *Helvering* v. *American Dental Co.*, *supra*. There, certain overdue interest and unpaid back rent were forgiven by the taxpayer's credi-

tors, who, as this Court held, received nothing of value for the release of those obligations. The Court held that the "release of something to the debtor for nothing" established that there was a gift of property under Section 22 (b) (3). But, as has been shown, in the present case each party to the transaction here has both received something of value and given up something of value.

Taking into account his present need for the money as well as his judgment of the probability of obtaining full payment at maturity, the receipt of money prior to maturity may have been as valuable to each creditor as the difference in price which he was compelled to receive. Conversely, the right to postpone payment until the date of maturity may have been as valuable to the taxpayer as was the monetary savings involved in satisfying the bonds at less than face value. These are personal elements of value which cannot be expressed in mathematical terms, for they include business judgments incapable of precise evaluation. These matters plainly forbid the conclusion that the taxpayer here received "something * * * for nothing" and that the satisfaction of the indebtedness was "gratuitous", as this Court found to be the case in the *American Dental* case.[5]

[5] Even if these elements of value were capable of measurement, the record here completely fails to establish that there was any difference in value between what the creditors gave up and what they received. As a result, there is no possible basis for holding that something gratuitous in the way of a gift passed to the taxpayer.

This case, in its pertinent facts, is governed by *United States v. Kirby Lumber Co.*, 284 U. S. 1, and *Helvering v. American Chicle Co.*, 291 U. S. 426, and by the long-standing Treasury Regulations the validity of which was specifically affirmed by those decisions. See Article 22(a)-14, Treasury Regulations 101, and Section 19.22(a)-14, Treasury Regulations 103.[6] In each of these cases, the debtor has purchased his own obligations prior to maturity and has been able to do so at less than their face amount. In each situation, being solvent, the debtor has in fact been enriched and realizes income to the extent that he is thereby able to increase his net worth.

The mistake of the Tax Court, in part, and of the Court of Appeals, in whole, results from a patent fallacy in an argument which runs as follows: There cannot be a gift unless there is some personal relationship or dealings between the parties; here there were personal dealings between the taxpayer and his creditors (in some of the transactions, according to the Tax Court—in all of the

[6] These provisions state that a taxpayer realizes income by the payment or purchase of his obligations at less than their face value, and make a cross reference to Article 22(a)-18 and Section 19.22(a)-18, which state that a corporation realizes taxable gain if it purchases its own bonds at less than the issuing price or face value. It was the latter provision which was involved in the *Kirby Lumber* and *American Chicle* cases. The principle that taxable gain is realized under these circumstances, as the Regulations plainly indicate, is equally applicable whether the taxpayer is an individual or a corporation.

transactions, according to the Court of Appeals); therefore, there were gifts here (in some of the transactions, according to the Tax Court—in all of the transactions, according to the Court of Appeals).

The defect in the reasoning is apparent, as was noted in the dissenting opinion in the Tax Court (R. 134):

> The majority opinion appears to go on the theory that all transactions carried on directly with personal acquaintances must be gratuitous. It is my opinion that while all gratuitous transactions will normally be carried on directly between personal acquaintances, not all transactions carried on directly between personal acquaintances are gratuitous. The instant case is an example.

This kind of fallacious reasoning, followed by the majority, however, has characterized some of the Tax Court's decisions in cases of this type subsequent to the decision in the *American Dental* case, *supra*. In *Fifth Avenue—14th Street Corp. v. Commissioner*, 2 T. C. 516, reversed and remanded on an evidentiary matter, 147 F. 2d 453 (C. C. A. 2), the Tax Court held that where the debtor corporation bought up its certificates of indebtedness prior to maturity and where there were no direct negotiations between the debtor and the certificate holders, the certificates being traded in the open market, there was no "gift" to the debtor. Although the Tax Court reached the correct result, it attempted to justify it on the infirm grounds of a lack of direct negotiations between

the parties. The same erroneous reasons were assigned in *Blake v. Commissioner*, 8 T. C. 546, although there, too, the proper result was achieved. However, in *Bulkley Bldg. Co. v. Commissioner*, decided October 25, 1944 (1944 P-H T. C. Memorandum Decisions, par. 44,342), where the debtor bought up its obligations at less than face value prior to maturity, some being purchased through direct transactions with the holders and some being purchased on the open market, the Tax Court ruled that the taxpayer realized taxable income where the obligations were purchased in the open market, but that non-taxable gifts resulted where the acquisitions were made through direct dealings.[7] The same distinctions

[7] The *Bulkley Bldg. Co.* case, as well as the present decision, may be contrasted with the result in *Warner Co. v. Commissioner*, 11 T. C. No. 53, decided September 27, 1948, where, in a decision which was not reviewed by the full Tax Court, Judge Leech (who was one of the dissenting judges in the present case) held that where the taxpayer acquired its own obligations at less than face value as a result of direct dealings, and where the prices paid were based on quoted prices in over-the-counter transactions to which the taxpayer had not been a party, there were no "gifts" and that United States v. *Kirby Lumber Co., supra*, controlled. Although the rationale of the opinion is not clearly expressed, it would seem plain that the controlling circumstance was that the "price" paid by the taxpayer was fair, a fact which was undeniable since the price was established by reference to other arm's length transactions and since the transactions in question were also conducted at arm's length. In such circumstances, the existence of a gift is conclusively negated. The Tax Court, in the *Warner* case, seems to have impliedly accepted what the Commissioner here contends is the proper approach to the construction of the statute.

were drawn in the present case and in *Edmont Hotel Co. v. Commissioner,* 10 T. C. 260, pending on the Commissioner's petition for review in the Court of Appeals for the Fifth Circuit.

It was by the application of this illogical rule that the Tax Court decided the present case. In all circumstances where the taxpayer was believed to have acquired his bonds as a result of direct negotiations with the bondholders, the Tax Court ruled that there was a tax exempt gift. However, where the taxpayer employed an intermediary to effectuate the purchase, it was held that there was no gift and that income was realized by the taxpayer. The Court of Appeals followed the same essential principle, but it disagreed with the Tax Court's evaluation of the evidence and, concluding that in all instances (even where the taxpayer acted through an intermediary) there were direct negotiations between the taxpayer and the bondholders, it held that there were gifts by the bondholders to the taxpayer, and that he realized income in none of the transactions.[8] Somewhat

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[8] The Court of Appeals seemed to think (R. 169–170) that the only difference between the *Kirby Lumber* and *American Chicle* cases, on the one hand, and the *American Dental* case, on the other, was the fact that in the former the bonds were acquired as a result of open market transactions while in the latter the cancellation of the indebtedness was achieved by direct negotiations between the debtor and his creditors. The court thus overlooked one important difference, which also serves to distinguish this case, namely, that in the *American Dental* case nothing of value was received by the creditor for the satisfaction of the obligation and, in that

the same kind of error characterized the decision of the court below in *Shellabarger Grain Products Co. v. Commissioner*, 146 F. 2d 177, where an obligation was paid prior to maturity at less than face value.[8]

We submit that the question whether a taxpayer has received a tax exempt gift under Section 22 (b) (3) cannot be resolved by the application of this kind of spurious principle.[9] Where, as here, values are exchanged in the transaction and the parties arrive at their agreement as the result of the exercise of business judgments, there is nothing gratuitous about the situation and there can be no tax exempt gift[10] of property within the purview of Section 22 (b)

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sense, what passed to the debtor was "gratuitous." The *Kirby Lumber* and *American Chicle*, as well as the present case, are different in that respect. Moreover, while the opinion in the *Kirby Lumber* case (284 U. S. 1, 2) did state that the bonds there were purchased in the "open market", the record in the case does not actually disclose how the purchases were effectuated or negate the existence of direct dealings between the debtor and the bondholders.

[9] In *A. M. Campau Realty Co. v. United States*, 69 F. Supp. 133, where the taxpayer purchased directly from its bondholders its own bonds which were in default, the Court of Claims, emphasizing the direct dealings, indicated by *dictum* that there was a partial gratuitous forgiveness of the indebtedness which was a gift under the *American Dental* decision. This opinion was vacated and withdrawn when a new trial was granted on July 7, 1947 (1947 C. C. H., par. 9355).

[10] For a criticism of the application of the *American Dental* doctrine to the present situation, as well as a disapproval of the doctrine itself, see 61 Harv. L. Rev. 1258.

(3). And certainly, where the same essential values are exchanged, the transaction does not fall within or without Section 22 (b) (3), depending merely upon whether the parties had direct negotiations or whether they dealt with each other through a market where securities are bought and sold.

II

THE EXISTENCE OF A GIFT UNDER SECTION 22 (b) (3) IS NEGATED WHERE THE TRANSACTION HAS A BUSINESS NATURE AND WHERE A DONATIVE INTENT IS ABSENT

Since, in accepting payment prior to maturity of an amount less than the face value of their bonds, the bondholders here did not extend anything gratuitous to the taxpayer, *Helvering* v. *American Dental Co.*, 318 U. S. 322, is plainly distinguishable for the reasons which have been set forth. The opinion in that case, however, contains language (particularly at pp. 330–331) which has given rise to confusion and misunderstanding in the Tax Court and other lower courts. The opinion states that there is a "gift of property" exempt from income tax under Section 22 (b) (3) wherever the "forgiveness" is "gratuitous", a "release of something to the debtor for nothing", and that the "fact that the motives leading to the cancellations were those of business or even selfish, if it be true, is not significant" (p. 331). This language, if taken literally, would suggest a construction of Sec-

tion 22 (b) (3) far beyond that intended by Congress and, we believe, by the Court. This language, unless clarified in the present case, will continue to be a source of considerable confusion to the lower courts and the bar. We urge the following considerations as grounds for clarifying the language appearing in the *American Dental* case.

A. *The intention of the parties is an important element for distinguishing between income subject to tax and property exempt as a gift*

The touchstone to the exclusion provisions of Section 22 (b) (3) lies in the intention that accompanies the transaction, rather than in academic notions of what would have been enforceable by the parties if their purposes had not actually achieved fruition and if the matter were still executory. Thus, the dividing line between a payment which, if compensatory, would be taxable income to the recipient, and a gift which would be tax exempt, has always been held to turn on the intention with which it was made. *Old Colony Tr. Co. v. Commissioner*, 279 U. S. 716, 730; *Bogardus v. Commissioner*, 302 U. S. 34. Both the majority and the minority in the *Bogardus case*, despite their differences regarding the proper function of the reviewing court, agreed that a payment intended as extra compensation for past services (which would not have been enforceable as an executory contract)

would not be a tax exempt gift. See also *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282. 289, fn 5, where it was said: "Whether a payment received is compensation within Section 22 (a) or is a gift within Section 22 (b) (3) is largely a matter of intention." See *Commissioner* v. *Smith*, 324 U. S. 177, 181–182.

The *American Dental* opinion, in appearing to make the "gratuitous" nature of the transaction the sole test of the existence of a tax-exempt gift, has unduly enlarged the scope of Section 22 (b) (3). Thus, in every sense of the word, the payment of additional compensation to an employee is "gratuitous." If the simple test of "something * * * for nothing" were employed and if the intention of the parties were completely disregarded, this type of payment, which is fairly frequent in the business world, would escape taxation as compensation to the employee, even though the employer clearly intended it to be compensatory. The *American Dental* language, if followed literally, would conflict with the principles of the *Bogardus* and *Old Colony Tr. Co.* cases even though those decisions were cited with approval there. We submit that a proper test under Section 22 (b) (3) must include the one applied in an impressive number of cases in the lower courts in following the ruling of the *Bogardus* and *Old Colony Tr. Co.* cases, namely, whether the parties intended a gift. See, e. g., *Fisher* v. *Commissioner*, 59 F. 2d 192 (C. C. A. 2); *Nickelsburg* v.

Commissioner, 154 F. 2d 70 (C. C. A. 2), and other cases cited in 1 Mertens, Law of Federal Income Taxation, Section 8.08, where such payments were taxed as compensation. The same test should possess great weight in determining the nature of payments between all parties, regardless of whether the relationship is that of employee-employer or that of debtor-creditor.

B. *A transfer made in the ordinary course of business is not taxable under the gift tax statute. The same transaction should not be a gift exempt from income tax*

Another reason why the *American Dental* opinion, if taken literally, would unduly enlarge the meaning of the word "gift" in Section 22 (b) (3) seems apparent from the relation between the exclusion provisions of the income tax and the coverage of the gift tax. The term "gift," as used in the gift statute, was employed in its most comprehensive sense. H. Rep. No. 708, 72d Cong., 1st Sess., p. 27 (1939-1 Cum. Bull. (Part 2) 457, 476); S. Rep. No. 665, 72d Cong., 1st Sess., p. 39 (1939-1 Cum. Bull. (Part 2) 496, 524); *Commissioner* v. *Wemyss*, 324 U. S. 303, 306. The gift tax statute, generally, dispensed with the test of donative intent and formulated one which employs the standard whether the transfer is for less than an adequate and full consideration in money or money's worth. Section 1002, Internal Revenue Code (26 U. S. C. 1002). Despite the sweeping nature of the con-

cept of gifts which Congress employed in imposing a tax on such transfers—a tax designed to implement the estate tax—it is important that "no genuine business transaction comes within the purport of the gift tax" (*Commissioner* v. *Wemyss, supra*, pp. 306-307). The Treasury Regulations plainly state that transfers "made in the ordinary course of business" are considered as made for an adequate and full consideration. Transactions made in the ordinary course of business are defined by the Treasury Regulations as "bona fide, at arm's length, and free from any donative intent." Section 86.8, Treasury Regulations 108, promulgated under the Internal Revenue Code. See II Paul, Federal Estate & Gift Taxation and 1946 Supp., Sections 16.07 and 16.14.

Thus, since ordinary business transactions are excluded from the scope of the gift tax, the creditors' forgiveness of the indebtedness in the *American Dental* case would seem not to be taxable as a gift because what occurred there appeared to be "bona fide, at arm's length, and free from any donative intent." [11]

Although a perfect integration between the estate, gift and income taxes is lacking, it is clear, at least, that a transaction which does not fall

[11] In the proper circumstances, forgiveness of a debt when not done in the ordinary course of business can constitute a taxable gift, and the Regulations so provide. See Section 86.2, Treasury Regulations 108.

within the sweeping coverage of the gift tax certainly cannot come within the exclusion provisions of the income tax under Section 22 (b) (3). See Paul, *supra*, 1946 Supp., Section 16.07. The word "gift" is unquestionably more embracing in its coverage under the gift tax statute than it is when used in an exemption section of the income tax. The *American Dental* language is, we respectfully submit, wrong in its implication that the contrary is true.

Even if the term "gift" in the two statutes were coextensive in coverage, and if the choice must be between taxing as income to the solvent debtor the amount of his cancelled indebtedness, or taxing as a gift by the creditor the debt which he foregoes as a result of a good faith business transaction, it is believed that the former would be the result ~~more probably intended~~ by Congress. See Lynch, Some Tax Effects of Cancellation of Indebtedness, 13 Fordham L. Rev. 145, 168 (1944).

It is urged that where the intention of the parties negates a donative purpose and where the forgiveness of an indebtedness is the result of an ordinary business transaction, there is no gift of property which is exempt from income tax by reason of Section 22 (b) (3). The application of this rule to the present case requires, *a fortiori*, the conclusion that the taxpayer did not receive a gift from the bondholders which would be exempt from income tax. It would also require the conclusion that no gift of property exempt under

Section 22 (b) (3) is involved in any situation where there is a reduction or cancellation of an indebtedness—without regard to whether this is accomplished before or after maturity, whether adequate, common law consideration is present or absent, and whether the transaction takes place in the open market or as a result of direct negotiations between the parties. If the creditor acts out of business reasons which preclude the existence of a donative purpose, there can be no gift of property within the intendment of Section 22 (b) (3).

C. *Legislation relating to cancellation of indebtedness shows that Congress does not conceive of a tax exempt gift occurring in a business transaction*

Congress has recognized the soundness of the rule that taxable income is realized when a debtor is able to discharge his indebtedness by payment of less than the amount of the obligation, and has, in effect, given legislative affirmation to the decisions in the *Kirby Lumber Co.* and *American Chicle Co.* cases by providing certain exceptions to the rule, but only under specified circumstances. The legislation, moreover, raises serious doubts respecting the correctness of the inferences to be drawn from the *American Dental* opinion.

Section 22 (b) (9), Internal Revenue Code,[12]

[12] As added by Section 215 (a) of the Revenue Act of 1939, c. 247, 53 Stat. 862, and as amended by Section 114 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, Section 152 of the

provides that in the case of a corporate taxpayer there shall not be included any income attributable to the discharge of any indebtedness which is evidenced by a security if the taxpayer consents to an adjustment in basis as provided for in the Treasury Regulations promulgated under Section 113 (b) (3) of the Internal Revenue Code. As presently constituted, Section 22 (b) (9) is effective only with respect to discharges of indebtedness occurring after the enactment of the Revenue Act of 1939 and before December 31, 1949.

Section 22 (b) (10) of the Internal Revenue Code[13] provides that in the case of a railroad corporation, there shall be excluded any income attributable to the discharge of any indebtedness by reason of a modification or cancellation of such indebtedness pursuant to an order of a court in a receivership proceeding or in a proceeding under Section 77 of the Bankruptcy Act, as amended. This section, too, is not effective with

Revenue Act of 1945, c. 453, 59 Stat. 556, Section 1, Act of July 31, 1946, c. 717, 60 Stat. 749, and Section 3, Joint Resolution of June 25, 1947, 61 Stat. 179 (26 U. S. C., Supp. I, 22 (b) (9)). Section 113 (b) (3) of the Internal Revenue Code, dealing with adjustments in basis, was also added by Section 215 (b) of the 1939 Act, *supra*.

[13] As added by Section 114 (b) of the Revenue Act of 1942, c. 619, 56 Stat. 798, and as amended by Section 152 of the Revenue Act of 1945, c. 453, 59 Stat. 556, Section 1, Act of July 31, 1946, c. 717, 60 Stat. 749, and Section 3, Joint Resolution of June 25, 1947, 61 Stat. 179 (26 U. S. C., Supp. I, 22 (b) (10)).

respect to discharges occurring after December 31, 1949. Unlike Section 22 (b) (9), *supra*, there is no provision requiring an adjustment in basis.

Various sections of the Bankruptcy Act provide that no income in respect to the adjustment of the indebtedness of the debtor shall be deemed to have been realized by reason of a modification in or cancellation of an indebtedness under the proceedings provided for in several of the chapters. See: Sections 268–270 of the Bankruptcy Act of July 1, 1898, c. 541, 30 Stat. 544, as added by Section 1 of the so-called Chandler Act, Act of June 22, 1938, c. 575, 52 Stat. 840, 904, and amended by Section 1, Act of July 1, 1940, c. 500, 54 Stat. 709 (11 U. S. C. 668–670), relating to proceedings under Chapter X of the Bankruptcy Act, dealing with corporate reorganizations;[14] Sections 395–396 of the Bankruptcy Act, as added by the Chandler Act and as amended by Section 2, Act of July 1, 1940, *supra* (11 U. S. C. 795–796), relating to arrangements under Chapter XI of the Bankruptcy Act; Sections 520–522 of the Bankruptcy Act, as added by the Chandler Act and as amended by Section 3 of the Act of July 1, 1940, *supra* (11 U. S. C. 920–922), relating to real property arrangements by persons other than corporations under Chapter XII of the Bankrupty Act; Section 679 of the Bankruptcy Act, as added by the Chandler Act (11 U. S. C. 1079),

[14] See *Claridge Apartments Co.* v. *Commissioner*, 323 U. S. 141.

relating to wage earners' plans under Chapter XIII.

Under the excess profits tax statute (which has since been repealed) in computing the credit based on average income, Congress provided that there should not be included in the excess profits net income of years in the base period any income derived from the retirement or discharge of certain evidences of indebtedness if the obligation was outstanding for more than six months. See former Section 711 (b) (1) (C), Internal Revenue Code, which was added by Section 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974, as amended by Section 207 (f), Revenue Act of 1942, c. 619, 56 Stat. 798.

The recognition by Congress of the need for some measure of "relief" or special treatment in these particular circumstances is, of course, cogent evidence that the basic principles underlying the *Kirby Lumber* and *American Chicle* cases possess continuing vitality. Unless a particular taxpayer can bring himself within the specific circumstances in which Congress has seen fit to postpone or to forgive the imposition of a tax on the gains, there is no reason for the creation of artificial judicial exceptions. As was pointed out in the dissenting opinion in the *American Dental* case, *supra*, p. 331, "When Congress wished to exempt income 'attributable to the discharge * * * of any indebtedness' it did so explicitly."

It is significant that in all the above instances

(with the exception of railroad reorganizations and wage earners' plans), Congress provided for certain readjustments in the basis of property, with the result that, to some extent at least, taxation of the profit realized through the discharge of the indebtedness is *merely postponed* until some future time. This should be contrasted with the result reached in the present case by the court below where the effect of the decision is to permit the taxpayer to escape taxation on the gains for all time.

The legislative measures, moreover, reveal the absence of any substantial basis for drawing the line, as the courts below did, between open market transactions and those resulting from direct negotiation. The discharge of an indebtedness by a modification or cancellation through the various proceedings provided for in the Bankruptcy Act does not, of course, result from open market transactions. Actually, agreement between the debtor and his creditors may frequently result in an acceptable plan. Consequently, it seems quite clear that Congress never envisaged a rule that discharges of indebtedness resulting from personal negotiations were, in all instances, to be automatically classified as tax exempt gifts of property to the debtor. On the contrary, Congress made exceptions to the general rule only in the enumerated instances, and those were not treated as tax exempt gifts to the debtor.

Furthermore, the legislation does not reveal that Congress shared the view expressed in the *American Dental* opinion that the modification or cancellation of the indebtedness is a gift to the extent that the debtor receives "something for nothing" from the creditor. In many instances where there are proceedings under the Bankruptcy Act, the creditor may receive nothing for the modification, reduction or cancellation of the debt. And even under Section 22 (b) (9), where the debtor purchases its obligation at less than face value after a default has occurred, the debtor receives something for nothing, as that phrase appears to have been used in the *American Dental* case, even though the obligation is acquired on the open market. See *Blake* v. *Commissioner*, 8 T. C. 546, where it was held that the debtor realized such income even though some of the bonds were purchased after they were in default.

The language in the *American Dental* opinion is therefore inconsistent with the Congressional understanding of the problem as evidenced by the foregoing legislative exceptions. See Eisenstein, Some Iconoclastic Reflections on Tax Administration (1945), 58 Harv. L. Rev. 477, 516, fn. 224.

CONCLUSION

The decision of the court below is erroneous and should be reversed with directions that the decision of the Tax Court be reversed on the Commissioner's petition for review and affirmed on the taxpayer's petition for review.

Respectfully submitted.

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